

DOES MONETARY POLICY WORK EFFECTIVELY IN 10 EUROPEAN COUNTRIES? NEW EVIDENCE FROM FISHER EFFECT

Tai-Hu Ling

Labuan School of International Business and
Finance Universiti Malaysia Sabah
lingtaihu@gmail.com

Venus Khim-Sen Liew

Department of Economics
Faculty of Economics and Business
Universiti Malaysia Sarawak

Abstract

This study examines the Fisher effect for 10 European Union countries over a period from January 1987 to December 2012. A battery of panel unit root tests shows that the monthly real interest rates in these countries are mean reverting. The series-specific panel SURADF test of Breuer et al. (2002) reveals that 9 country series reject the unit root null hypothesis, except for 1 country series. These results have one extremely important policy implication is that monetary collaboration within 10 European counties is the key determinant to achieve the long-run macroeconomic stability. Policy makers in European Central Bank need to closely monitor the monetary stability particularly in Luxembourg towards establishing a strong European monetary union.

Keywords: *real interest rate, panel SURADF, Fisher effect, panel unit root*

JEL classifications: E4, G1

Introduction

Over the past decades, the process of the economic and monetary union formation started in 1990 has led to a robust change in the monetary policy in the Euro countries. It involves the coordination of economic and fiscal policies, a common monetary policy, and a common currency. In 1999, the establishment of European Monetary Union has led to the creation of European Central Bank (ECB) to fully regulate and govern monetary stability for the Euro area. Thus, it is widely believed that monetary policy effectiveness in Euro countries has greatly improved since it is regulated by the most accountable and transparent central bank in the world, see Gros and Bini-Smaghi (2011), and Blinder et al. (2008). Recently, using fractional integration, Meller and Nautz (2012) find that the inflation persistence has significantly dropped in the ten Euro countries mainly due to more effective monetary policy of the ECB. However, the study of inflation persistence may not truly uncover the effectiveness of monetary policy without examining the Fisher effect. In order to reveal more findings on this issue, this paper examines the Fisher effect for 10 Euro area countries.

Irving Fisher (1930) postulates that nominal interest rates and predicted inflation rates should move together one-for-one in the long run. The analysis of Fisher effect has been voluminous among economists. First, it serves an extreme implication to the extent that whether policymakers can determine the nominal interest rate as a tool for stabilizing price level (Tsong and Lee, 2013). In other words, the Fisher effect serves as an indicator of monetary policy effectiveness. Second, it also has important consequences in the adoption of consumption-based capital asset pricing model by international investors who regularly adjust their consumption and investment plans (Costantini and Lupi, 2007; Rose, 1988). Testing the mean reversion of real interest rates has been the prevailing method to scrutinize the Fisher effect. However, the empirical evidence in the literature of addressing this hypothesis has been virtually no support to this long-standing theoretical model or mixed at best.